United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-7067

To be argued by
ALFRED S. JULIEN

In The

United States Court of Appeals

For The Second Circuit

UNITED STATES FIDELITY & GUARANTY COMPANY,

Plaintiff-Appellant,

vs.

ROYAL NATIONAL BANK OF NEW YORK and MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York (C.D. 68 Civ. 2054 (H.F.W.))

BRIEF FOR PLAINTIFF-APPELLANT

JULIEN & SCHLESINGER, P.C.
Attorneys for Plaintiff-Appellant
2 Lafayette Street
New York, New York 10007
(212) 962-8020

ALFRED S. JULIEN
STUART A. SCHLESINGER
DAVID JAROSLAWICZ
SAMUEL KOMOROFF
Of Counsel

(9568)

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Questions Presented for Review

1. Was the district court correct in finding that the defendants observed reasonable commercial standards in accepting and purchasing $212,000 worth of stolen treasury notes under highly suspicious circumstances?

2. Was the district court correct in finding that under Gutekunst v. Continental Insurance Company, 486 F.2d 194 (2d. Cir. 1973), a bank need never investigate the customer with whom it is dealing and the circumstances of the transaction?

3. Was the district court correct in finding that a bank has a right to deal with a customer of a bank even under the most suspicious circumstances and still be said to have acted in good faith?

4. Was the district court correct in finding that a brokerage firm in purchasing securities through a bank had a right to rely upon the bank being its customer although it had knowledge that the treasury notes were being sold for the account of an individual and not for the bank's account?

5. Was the district court correct in finding that the plaintiff is precluded from recovery because it did not discover that its treasury notes had been stolen or lost for a period of time and in the interim the thief had sold the treasury notes through and to the defendants.

Statement of the Case

Plaintiff, United States Fidelity & Guaranty Company ("USF&G") is appealing from a judgment and order of the Honorable Henry F. Werker of the United States District Court for the Southern District of New York, entered on January 15, 1976, dismissing USF&G's complaint and awarding judgment to the defendants (7-18).*

The plaintiff had commenced an action for conversion against the defendants Royal National Bank of New York ("Royal") and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") for the role they played in the conversion of United States Treasury Notes having a par value of $212,000 (25, 44). These treasury notes had been stolen from W. E. Hutton & Company ("Hutton") (7) between May 15, 1966 and August 1966. USF&G was Hutton's insurance company and after paying Hutton's claim brought this action as Hutton's assignee.

After a four-day trial before the Court and without a jury on August 6, 7, 8 and 11, 1975, Judge Werker on January 12, 1976 filed an opinion (7-18), finding that Royal, through which the stolen treasury notes had been negotiated, and Merrill

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*All page references are to the joint appendix unless otherwise indicated.

Lynch, which had purchased the stolen treasury notes, observed reasonable commercial standards in accepting the treasury notes and the defendants could not have known that the notes were stolen and, accordingly, entered a judgment in favor of the defendants dismissing USF&G's complaint.

The plaintiff is appealing from that judgment dismissing its complaint on the grounds that Judge Werker's findings that the defendants had observed reasonable commercial standards in accepting the stolen treasury notes are clearly erroneous. The evidence contained in the record makes it clear that the defendants did not observe reasonable commercial standards in accepting the treasury notes, that they ignored highly suspicious circumstances in accepting them and that USF&G was entitled to a judgment against the defendants.

Statement of Facts

On March 15, 1968 one Frank Mazzochi, Jr. ("Mazzochi") was convicted in the Supreme Court of the State of New York, Bronx County, of criminally concealing and withholding stolen and wrongfully acquired property (45). The property underlying Mazzochi's conviction consisted of 26 United States Treasury Notes with a par value of $212,000 (25, 44). These treasury notes had belonged to Hutton and had been stolen from a vault at the Bankers Trust Company where they had been deposited for safekeeping by Hutton.

Some time between May 15, 1966 and August 1966, these notes had been stolen from Hutton's vault. Hutton was unaware that the securities were missing until late August or early September 1966 (365). The bonds were discovered missing during a periodic inventory taken by Hutton (364). Immediately after the bonds were discovered missing Hutton began an extensive search to determine whether the securities had been mislaid or misfiled (366).

After the search was completed, it became obvious that the securities had not been mislaid but had been stolen (367). Hutton immediately began to review its records and the serial numbers of the treasury notes still in its possession so as to be able to compare the serial numbers of the notes which it still had with the serial numbers which it had recorded during its last inventory which had previously taken place on or about May 15, 1966 (393). After all the missing numbers were discovered, Hutton then began the process of accounting for those treasury notes which it had disposed of by a legitimate means. This investigation was not completed until on or about September 27, 1966.

As soon as Hutton determined which treasury notes were missing it prepared a list of those securities and forwarded it to its insurance broker in Cincinnati, Ohio (368, 635-636). A short time later, USF&G paid Hutton's

claim (637) and thus became the assignee of Hutton's right to recover the stolen treasury notes (45).

In the interim, between August 5th and September 12th, 1966, Mazzochi had sold all of these treasury notes through the defendant Royal's branch bank at 149th Street in the Bronx and later withdrew the proceeds of those sales in the amount of $211,887.00.

On August 5, 1966, Frank Mazzochi, Jr., a young man who appeared to be in his late twenties (79), entered Royal's branch bank at 149th Street in the Bronx and approached Rudolph Santoro ("Santoro"), a clerk in the loan department of the bank (74). Mazzochi presented a $10,000 treasury note to Santoro and advised him that he wanted to sell the treasury note. Santoro, who was ordinarily a clerk in the bank's credit department (71), and was only acting as head of the bank's loan department because the person normally in that position was on vacation (74), referred Mazzochi to Robert Kayner ("Kayner"), one of the bank's credit officers, to have him approve the transaction (82).

Mazzochi advised Kayner that the treasury note belonged to his family (228) and Kayner, without requesting any documentation to indicate that Mazzochi was properly in possession of this $10,000 treasury note, immediately approved

its sale. On August 5, 1966 when Mazzochi approached Santoro and Kayner with the $10,000 treasury note, Santoro did not know Mazzochi by name and had had no prior dealings with Mazzochi. Santoro did recognize Mazzochi as a person whose face he had previously seen in the bank (76). Kayner, the bank officer who approved the sale, likewise had had no prior dealings with Mazzochi prior to August 5, 1966 (217, 221).

Having tested the waters and determined that Royal was willing to accpet these treasury notes from him, Mazzochi on that same afternoon of August 5, 1966 returned to the bank with an additional $60,000 worth of treasury notes in the same series (92-93). Again, Santoro referred Mazzochi to Kayner and Kayner immediately gave his approval for the bank to accept the additional $60,000 in treasury notes from Mazzochi.

On August 5, 1966, these treasury notes were sold by Royal to the defendant Merrill Lynch (638, 639). The transfer slips from Royal to Merrill Lynch clearly state on their face that these transactions were "for the account of Frank Mazzochi, Jr.' (638-639).

August 5, 1966 was a Friday. On Tuesday, August 9, 1966, Mazzochi again returned to the bank and this time produced $70,000 worth of treasury notes in the same series

(126, 44). Again, the same scenario was followed where Mazzochi initially approached Santoro who said to Mazzochi "You have more treasury bills? When is it going to stop?" (134). But, nevertheless, Santoro requested no documentation of any sort, but simply referred him to Kayner. Kayner similarly requested no documentation, but approved the sale of the additional $70,000 in treasury notes. These were likewise sold to Merrill Lynch and the bank's transmittal slip to Merrill Lynch clearly stated that the transaction was "for the account of Frank Mazzochi, Jr." (640).

During the initial transaction on August 5, 1966, Mazzochi had requested a bank check for the proceeds of the treasury notes made out to himself (114, 123). However, the bank requested that Mazzochi open a checking account to which the proceeds of the treasury note sales would be deposited and at the bank's request, Mazzochi did so. Santoro admits that to any experienced bank officer, Mazzochi's request that he be given a bank check for the proceeds was highly suspicious and indicated that Mazzochi did not want the funds to be passing through any bank account (115-116).

The proceeds from the sales of the treasury notes amounting to $140,192.02 were deposited in Mazzochi's checking account opened for this very purpose on August 9 and 10, 1966

(44). Mazzochi wasted no time in starting to withdraw the proceeds from the sale of the treasury notes. All of these withdrawals were made in cash (44), the dates of the withdrawals being as follows:

Date	Amount
8/9/66	$35,000
8/10/66	13,000
8/12/66	10,000
8/15/66	10,000
8/16/66	10,000
8/17/66	10,000
8/18/76	10,000
8/19/76	10,000
8/22/76	10,000
8/23/76	10,000
8/29/76	10,000

Despite Mazzochi's suspicious actions on their face in making these withdrawals indicating that something was wrong, the bank did nothing.

Mazzochi realizing that he had found a method by which he could dispose of the stolen treasury notes again entered the bank on September 12, 1966, this time producing $72,000 worth of treasury notes (44). Again, Mazzochi

approached Santoro (146). At this point, even Santoro began to have what he termed "misgivings" (147) about the bank's transactions with Mazzochi. Despite his misgivings he simply accepted the treasury notes from Mazzochi and referred him to a bank officer to approve this new transaction for $72,000. Since Kayner was unavailable, Santoro brought this latest transaction to the attention of Edward I. McGraw ("McGraw"), another officer of the bank. Santoro informed McGraw that the bank had previously sold $140,000 worth of treasury notes for Mazzochi. Santoro conveyed his misgivings about this additional $72,000 worth of treasury notes to McGraw (148), but McGraw ignored the direct warning of suspicious circumstances which he had from Santoro and nevertheless authorized Royal to sell the additional $72,000 worth of treasury notes (149).

Neither Santoro nor McGraw bothered to check the bank's own records to determine if Mazzochi had withdrawn the proceeds from the prior treasury note sales of $140,000 (149). Again, as with the prior $140,000, the treasury notes were sold to Merrill Lynch with the bank's transmittal notice clearly advising Merrill Lynch that the transaction was "for the account of Frank Mazzochi, Jr." (641).

After Royal had sold the stolen treasury notes for Mazzochi on September 12, 1966, apparently someone at the bank for the first time decided to check the bank's records to determine what had happened to the proceeds from the

sales of the prior $140,000 worth of treasury notes which Royal had accepted from Mazzochi. Accordingly, on September 15, 1966, McGraw advised Walter, another bank officer, that the proceeds from the first $140,000 in treasury notes had been withdrawn in cash by Mazzochi and the bank had, therefore, placed the proceeds from the sale of the last $72,000 in treasury notes in a suspense account "pending determination of the propriety of the transactions" (693) or, as McGraw told another bank officer, he was "suspicious of the bonds" (779). At this point, however, it was no longer a question of the bank accepting stolen treasury notes from Mazzochi, but the bank was holding funds which belonged to Mazzochi and a debtor-creditor relationship had been created (158).

When it was clear to all concerned that Mazzochi was obviously selling treasury notes which were either stolen or which he had come into possession of by some other illegal method and even the bank had finally realized that Mazzochi clearly did not have the right to sell the treasury notes in question and had placed the proceeds from the sale of the notes in a suspense account, Royal still did not request or require Mazzochi to produce any documentation of any nature whatsoever to show that he had a right to dispose of the $212,000 worth of treasury notes or where he had obtained them.

In what seems absurd on its face, Royal asked Mazzochi, whose credibility and credentials it was admittedly suspicious enough of at this point to place his funds in a suspense account, to execute an affidavit confirming that he was the owner of the treasury notes which he had negotiated at R [illegible]77, 979, 987, 1000, 1004). On September 20, [illegible]omptly executed the affidavit swearing that he [illegible] owner of the treasury notes (691-692). The bank after receiving the affidavit from Mazzochi, required no other proof from Mazzochi as to how he had come into the possession of the treasury notes, but on September 29, 1966 credited the proceeds of the additional $72,000 in treasury notes to Mazzochi's account (44). Mazzochi immediately withdrew $10,000 on Friday, September 30, 1966 and an additional $60,000 on October 3, 1966, the following Monday (45). These withdrawals were likewise in cash (44).

Shortly thereafter, Mazzochi was indicted and on March 15, 1968 was convicted of criminally concealing and withholding stolen property.

At the trial of this action the bank contended that it had observed reasonable commercial standards in all of its conduct with respect to accepting these treasury notes from Mazzochi. The bank further contended that it had made all of the inquiries which it was required to make (47).

Royal bases its position that it observed reasonable commercial standards in dealing with Mazzochi and in accepting $212,000 worth of treasury notes from him in a six-week period on the fact that Mazzochi was an officer of a local credit union (247-248) and maintained several other accounts with the bank (885). The facts reveal that this mutual credit union which Mazzochi was an officer of had maintained an average balance with the bank of between $1,000 and $2,000 (248, 862, 941). The evidence also reveals that one of Mazzochi's other accounts with the bank had written upon it in red "caution uncollected" (774) which meant that the bank was not to make any payments on that account against checks which were deposited and which funds had not yet been collected (774, 1152).

The evidence also reveals that Royal had not acted in a reasonable commercial manner in investigating Mazzochi since no investigation at all was undertaken by the bank. The only investigation the bank claims it could possibly have undertaken was Santoro's claim that prior to accepting the treasury notes from Mazzochi on each of the three days, he called the Federal Reserve Bank in New York City and asked if the treasury notes presented by Mazzochi were listed as having been stolen (166).

Santoro's testimony is incredible on its face and directly contradicted by the testimony of Stephen Weis ("Weis"), who is presently employed by the Federal Reserve Bank and at one time was Chief of the Government Bond Division of the Federal Reserve Bank (295). Weis stated in unequivocal terms that the Federal Reserve Bank in New York did not keep a listing of stolen or lost treasury bills and that anyone who inquired would be referred to the Bureau of the Public Debt in Washington, D.C. (294).

Merrill Lynch at the trial of the action took the position that it acted in a reasonable commercial manner in purchasing these treasury notes because it was dealing with a bank which was its customer and, therefore, did not violate Section 405 of the New York Stock Exchange, commonly known as the "know your customer" rule (49).

The evidence clearly shows that each of the transmittal notices by Royal to Merrill Lynch indicated that the treasury notes were sold for the account of Mazzochi (638-641). Merrill Lynch was aware that the bank did not trade for its own account out of the 149th Street office in the Bronx, but through its main branch in New York City. Merrill Lynch was aware that any transactions from branch banks were not for the bank's own account, but for customers. Merrill Lynch did nothing to

determine who this customer of Royal's from whom it was purchasing $212,000 worth of treasury notes was.

In light of the foregoing facts, the district court conclusion that the defendants observed reasonable commercial standards in purchasing the stolen treasury notes and accordingly dismissing USF&G's complaint was clearly erroneous.

ARGUMENT

POINT I

THE DISTRICT COURT'S FINDINGS OF FACT WERE "CLEARLY ERRONEOUS" IN FINDING THAT THE DEFENDANTS HAD OBSERVED REASONABLE COMMERCIAL STANDARDS IN ACCEPTING THE TREASURY NOTES IN QUESTION.

The findings of the District Court that the defendants had observed reasonable commercial standards in accepting $212,000 worth of stolen treasury notes from Mazzochi without making any attempt to determine whether Mazzochi had a right to sell those treasury notes are clearly erroneous.

Rule 52(a) of the Fed.R.Civ.P. provides in pertinent part that:

> "In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 57; ... Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

The accepted definition of when a finding is clearly erroneous has been set forth by the Supreme Court in U.S. v. U.S. Gypsum Co., 333 U.S. 364, 68 S.Ct. 525 (1948). The Court there stated:

> "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." (333 U.S. at 395)

This Court in Feder v. Martin Marietta Corporation, 406 F.2d 260, 264 (2d Cir. 1969), stated what procedures it followed in determining whether or not a district court's decision should be set aside by an appellate court:

> "The procedure we follow in the review of the factual findings below is succinctly set forth in Schley v. CIR, 375 F.2d 747, 757-758 (2 Cir. 1967) (dissenting opinion):
>
> > When lower court determinations are reviewed by the appellate court, the appellate court must look first to the findings of the court below * * *; then the appellate court may examine all the evidence in the record to ascertain whether those findings are "clearly erroneous." The appellate court, to be sure, must give great weight to the inferences drawn by the trial court, but it is equally true that the appellate court may reject those inferences if they are clearly erroneous inferences and have led to a mistaken result."

See also Zenith Corp. v. Hazeltine, 395 U.S. 100, 123, 89 S.Ct. 1562 (1969).

A review of the complete record and all of the evidence in our case makes it clear that the District Court's findings are clearly erroneous, and that this Court cannot help but find that a mistake has been committed.

The District Court in its decision relied upon findings which are directly contradicted by the record. Other findings by the District Court, although contained in the record, are

taken out of context and in the context of all of the evidence in the case stand for a proposition directly contradicting that which the District Court found.

Among other things, the District Court made the following findings:

a. That Hutton's system for maintaining its treasury notes was casual, careless and insecure (8).

b. That Mazzochi who was convicted of having possession of the stolen treasury notes had come to the bank with good recommendations which the bank had a right to rely upon (10).

c. A bank employee, Santoro, called the Federal Reserve Bank to determine if the treasury notes were stolen or missing before accepting them (11-12).

d. That the bank, after placing the proceeds from the last $72,000 worth of treasury notes in a suspense account, acted properly in releasing them without any proof that Mazzochi had a right to these treasury notes or where he had obtained them but simply relied upon an affidavit by Mazzochi swearing that he was their rightful owner (13-14).

e. The District Court found that the plaintiff's expert as to reasonable commercial standards, Mr. Frank W. Sixt, with over 40 years of experience in the banking busi-

ness, was biased, and that Mr. Sixt's testimony was that the bank should not have dealt with Mazzochi under any circumstances (16).

f. The Court below found that Merrill Lynch had a right to rely upon the fact that the bank was forwarding the treasury notes to it without inquiring as to who Mazzochi was although they were advised by the bank that the treasury note transactions were for Mazzochi's account (17).

g. The District Court found that the Royal Bank had had no problems with Mazzochi's corporate account (15).

h. The Court below speculated and found that Hutton's failure to promptly report the loss of the treasury notes might have been a factor which prevented Royal Bank from determining that Mazzochi's treasury notes were stolen from Hutton (17-18).

As will be shown, each of these findings by the District Court is clearly erroneous and directly contradicted by the record:

a. The record rather than reflect that Hutton's system for maintaining its treasury notes was casual, careless and insecure instead reflects, as the District Court was compelled to admit, that the treasury notes which were stolen were maintained in a vault in the Bankers Trust Company at 14 Wall Street, New York City. The record further indicates that as soon as it was discovered during a routine inventory

that certain treasury notes might be missing, Hutton conducted an extensive search, including a search through the trash which was retained by the bank and preserved in bags (366). It was only after this search ha. been completed, and it was ascertained that the treasury notes were missing or stolen, that Hutton began to review its records of treasury notes so as to determine which serial numbers were missing (367). There is absolutely nothing in the record at all which supports the Court's finding that Hutton's system for maintaining its treasury notes was casual, careless and insecure.

b. Among the principal findings made by the Court which prompted it to dismiss the plaintiff's complaint was the finding that Mazzochi, who was convicted of possessing the stolen treasury notes, had allegedly come to the bank with good recommendations (10). The record is to the contrary. The principal recommendation relied on by the Court is the fact that Mazzochi was an officer of the Mutual Credit Union which had been a customer of the bank since around 1950 (10). The Court ignores the evidence in the record that the Mutual Credit Union was a small local office whose average credit balance was between one and two thousand dollars (248, 862, 941). The man who allegedly introduced Mazzochi to the bank and according to McGraw, one of the bank's officers,had notified him that Mazzochi came from a wealthy family (1017, 1020) directly denied having made any such statements. That

man, Arnold Dutchen, a member of the credit union, stated that when he brought Mazzochi into the bank he introduced him by saying simply "he is Frank Mazzochi, he is the new president, and that is it". That was the extent of the introduction (1086, 1090, 1091). Mazzochi, in essence, had no recommendations to the bank except for the fact that the bank knew he was associated with the credit union.

c. The Court found that a bank employee, Santoro, had called the Federal Reserve Bank to inquire as to whether or not the treasury notes had been reported missing or stolen prior to accepting them for sale (11). Santoro's testimony that he called the Federal Reserve Bank (151, 167) is incredible and unworthy of belief since a witness from the Federal Reserve Bank, Weis, testified that the Federal Reserve Bank did not keep a list of stolen or missing treasury notes, and if anyone called for such information, he would be referred to the Bureau of the Public Debt in Washington, D.C. (294). Even the District Court was compelled to admit in its findings that Santoro's testimony that he routinely called the Federal Reserve Bank prior to accepting Mazzochi's treasury notes was questionable (11, 12).

d. The District Court found that the bank acted properly in releasing the proceeds from the last $72,000 worth of treasury notes from a suspense account without any proof that Mazzochi had a right to those treasury notes or where he had obtained them but simply relied upon an affidavit made by Mazzochi swearing that he owned them.

When Mazzochi brought in the last $72,000 worth of treasury notes on September 12, 1966, Santoro began to have misgivings (147), which he conveyed to McGraw, the bank's officer whose approval was being sought to negotiate the last batch of treasury notes. In spite of these misgivings, McGraw approved their sale by the bank (918, 963). Neither McGraw or Santoro checked the bank's records to determine if Mazzochi had withdrawn the $140,000 in proceeds from the two prior sales of treasury notes (149, 924).

Apparently, after accepting the last batch of $72,000 worth of treasury notes, even the bank realized that Mazzochi had no right to be selling these treasury notes, and McGraw, the officer at the bank who had originally met Mazzochi and dealt with him on behalf of the credit union, directed that the proceeds from the sale of the last $72,000 worth of treasury notes be held in a suspense account (779, 693).

Even after the proceeds were in a suspense account and the bank was suspicious of the propriety of the transactions, the bank nevertheless failed to ask Mazzochi for any proof at all that he had a legitimate right to the treasury notes and failed to request any documentation showing where Mazzochi had obtained the notes or how he had obtained them. Instead, what the bank did was request Mazzochi to execute an affidavit advising them that Mazzochi was the rightful owner of the treasury notes (976- 77, 979, 785, 1000, 1004).

This Mazzochi did unhesitatingly. The plaintiff submits that if a bank is suspicious enough of its customer to warrant placing the proceeds from a treasury note sale into a suspense account, then that customer's credibility with the bank is not of such a nature so that an affidavit by that customer is dispositive of the issue as to whether or not that customer is a thief or if he has rightful possession of the treasury notes.

No matter what the bank's actions were in buying the treasury notes from Mazzochi originally, once they were suspicious enough to place the treasury notes in a suspense account, they were required to do far more than to obtain an affidavit from Mazzochi that he had a right to dispose of the treasury notes before releasing $72,000 in proceeds to him.

e. The Court found that the testimony of the plaintiff's expert, Frank W. Sixt, as to what constituted reasonable commercial standards on the part of the bank was biased (16). In order to clearly see that Sixt's testimony was anything but biased and properly set forth as to what constituted reasonable commercial standards, the complete testimony of Sixt is available in the appendix (661-665, 485, 528). In essence, Sixt's testimony was that whereever you have a small customer who suddenly presents large amounts of money, it is a prudent banking practice to

establish that he has a right to those notes (508). Sixt went on to explain that prudent practice requires you to obtain a confirmation slip or other evidence where the customer had obtained the treasury notes he was attempting to sell (549). Sixt was anything but biased and stated that based upon the fact that Mazzochi was associated with the credit union, he perhaps would have accepted the first treasury note presented on August 5, 1966 for $10,000 from Mazzochi (553). However, after Mazzochi produced $60,000 worth of treasury notes on that same afternoon of August 5, 1966 and then an additional $70,000 worth on August 9, 1966, it was clear this was an unusual transaction (566). In addition, the fact that Mazzochi was withdrawing the proceeds as soon as they were deposited was likewise highly suspicious. The District Court's finding that Sixt's testimony was biased and that according to Sixt the bank should have refused to deal with Mazzochi (16) is contradicted by the record.

Sixt, no place in his testimony, stated that the bank should have refused to deal with Mazzochi. Sixt testimony simply stated that the bank should have obtained some sort of documentary evidence from Mazzochi, preferably a broker's confirmation slip as to where he had obtained this large amount of treasury notes prior to selling them. This is far different from the Court's finding that Sixt's testimony was that the bank should have refused to deal with Mazzochi under any circumstances.

f. The District Court's found that Merrill Lynch had a right to rely upon the fact that the bank was forwarding Mazzochi's treasury notes to it without inquiring as to who Mazzochi was since the bank was Merrill Lynch's customer. Each time the bank transmitted treasury notes to Merrill Lynch, the transmittal slip clearly stated that the transaction was "for the account of Frank Mazzochi, Jr."(638-641). In addition, Merrill Lynch was aware that these treasury notes were coming from the bank's Bronx branch at 149th Street and not from its main office. When the bank bought or sold securities for its own account, they always came from the main office in Manhattan (202-205). There is nothing in the record which supports Merrill Lynch's right to claim that it relied upon the bank as its customer when it knew that the treasury notes were being sold by Mazzochi and not by the bank.

The District Court's finding that if Merrill Lynch had inquired of the bank who Mazzochi was, it would have merely been informed that he was a customer of the bank (170) is a totally speculative finding made by the Court which has no support in the record. It is alot more probable that if Merrill Lynch had inquired,as it was bound to, who Mazzochi was and where he had obtained the treasury notes in question, the bank may have asked Mazzochi that very same question and found that Mazzochi had no plausible explanation for how he had obtained possession of $212,000 worth of treasury notes.

g. The District Court found that the bank had a right to deal with Mazzochi and accept treasury notes from him with no inquiry whatsoever because the accounts Mazzochi maintained at the bank did not cause the bank any problems (15). This is likewise directly contradicted by the record. The record is clear that one of Mazzochi's accounts was marked with a red flag,that no payments were to be made upon it for uncollected funds (774, 861, 1152). This is hardly the kind of impeccable customer from whom the bank may accept $212,000 worth of treasury notes with no investigation or questions at all. In addition, the transactions engaged in by Mazzochi with regard to the treasury notes were far in excess of any transactions which Mazzochi had had in any of his accounts with the bank. The accounts which Mazzochi had with the bank had balances in them of approximately $500 (868), not $212,000, or anything even approaching $10,000, the amount of the very first treasury note.

h. The Court found that Hutton's failure to promptly report the loss of the treasury notes may have been a cause of the bank's permitting Mazzochi to sell the treasury notes (17). The Court below's position is totally unsupported by the facts. The testimony is uncontradicted that Hutton was unable to ascertain which treasury notes were missing until September 27, 1966 (381, 425, 465) At that time, Mazzochi had already withdrawn the proceeds of the first $140,000 in treasury notes, and the bank, despite

the clearly suspicious nature and misgivings it had when Mazzochi had presented the last $72,000 worth of treasury notes on September 12, 1966 (147),had nevertheless permitted Mazzochi to sell the treasury notes. The evidence is also uncontradicted that even after placing the monies in a suspense account, the bank did not require Mazzochi to produce any evidence that he was in proper possession of the notes but simply permitted him to supply an affidavit to that effect (976-77). Had the bank required Mazzochi to produce some evidence that he was the owner of the notes, then Mazzochi would never have been permitted to obtain the last $72,000 worth of treasury notes. It is the last $72,000 worth of treasury notes which are the only ones which could possibly have been effected by Hutton's so-called delay in promptly reporting the loss,which it was unaware of and could not specify until at least September 24, 1966, even according to the Court. The first $142,000 had already been withdrawn by Mazzochi by August 29, 1966, long before Hutton was able to determine which treasury notes were missing.

From the foregoing, it is clear that the Court's findings of fact upon which it based its decision dismissing the plaintiff's complaint are clearly erroneous, unsupported by the record and in fact are directly contradicted by the record. As will be shown, the only defense available to the bank, who admittedly received stolen treasury notes belonging to the plaintiff, is that they acted in a manner which observed reasonable commercial standards in accepting these treasury notes

since the facts make it clear that the defendants' behavior, particularly the bank's, was not one observing reasonable commercial standards, but rather was one of gross negligence, the decision of the Court below must be reversed and judgment entered for the plaintiff for the full amount of the notes converted by the defendants.

POINT II

THE DEFENDANTS IN DEPRIVING USF&G OF TREASURY NOTES WHICH IT HAD A RIGHT TO POSSESS ARE LIABLE FOR CONVERSION.

The defendants admit that the bank received certain treasury notes from Mazzochi which notes were sold to Merrill Lynch (43, 45). Under the common law, a purchaser of stolen property, even if purchased in the utmost good faith, is liable for conversion for depriving the rightful owner of control over his property. See Federal Insurance Company v. Fries, 355 N.Y.S.2d 741, 744 (1974). The Restatement of Torts 2d, Volume 1, Section 222A(1) defines tortious conversion as:

> "an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the full value of the chattel."

The common law doctrine which makes all persons who aid or abet in the conversion of property strictly liable to its rightful owner has been ameliorated in certain instances by the Uniform Commercial Code.

UCC 8-318 provides as follows:

"No Conversion by Good Faith Delivery

> An agent or bailee who in good faith (including observance of reasonable commercial standards if he is in the business of buying, selling or otherwise dealing with securities) has received securities and sold, pledged or delivered them according to the instructions of his principal is not liable for conversion or for participation in breach of fiduciary duty although the principal had no right to dispose of them." (emphasis added)

The touchstone of UCC 8-318 is "good faith". Good faith on the part of entities such as banks, brokerage houses and other commercial institutions includes the observance of "reasonable commercial standards." This means that a bank or brokerage house must prove that it followed the custom and practice with respect to reasonable commercial standards in dealing with a converted security and in order to be able to take advantage of the good faith defense made available to it by UCC 8-318.

As set forth in the statement of facts, Royal did not observe reasonable commercial standards in accepting $212,000 worth of treasury notes from Mazzochi who, although a customer of the bank, the bank had no knowledge of with respect to background or financial status and his prior dealings with the bank either on his own behalf or on behalf of the credit union of which he was an officer usually were in the area of $1,000 to $2,000 (248, 862, 941).

The bank's own actions in placing Mazzochi's proceeds from the last $72,000 sale of treasury notes in a suspense account because it was suspicious (779) and wished to determine the propriety of the transactions (693) is sufficient to indicate that the observance of reasonable commercial standards did not permit the bank to accept $212,000 in treasury notes from Mazzochi especially in the manner in which the transactions took place, including Mazzochi's withdrawals in cash of the proceeds of the treasury notes as soon as they were obtained (44-45).

The New York Court of Appeals in Soma v. Handrulis, 277 N.Y. 223 (1938) stated:

> "Even if the actual good faith of the Federal Reserve Bank in dealing with the instrument is not questioned, if the facts shown by the instrument itself should have led it to inquire, and by inquiry it would have discovered the true situation, in a commercial sense it acted in bad faith and the law will withhold from it such protection as it would otherwise have been entitled to receive . . . " 277 N.Y. at 233-234.

The official comment to UCC 8-304 provides that:

> "Also suspicious characteristics of the transaction may give a purchaser (particularly a commercially sophisticated purchaser such as a broker) 'reason to know'. U.S.F. & G. Co. v. Goetz, 285 N.Y. 74, 32 N.E.2d 798 (1941), Morris v. Muir, 111 Misc. 739, 180 N.Y.S. 913 (1920)."

likewise making it clear that an institution such as a bank under the circumstances in our case upon the exercise of reasonable commercial standards would have known that Mazzochi did not have a right to sell the $212,000 worth of treasury notes or at least the bank had a duty to inquire where Mazzochi had suddenly obtained his new-found wealth.

Once a duty of inquiry exists, the party who should have made that inquiry is chargeable with the knowledge that an inquiry would have imparted. Munn v. Boasberg, 292 N.Y. 5 (1944). In Rochester & C.T.R. Co. v. Paviour, 164 N.Y. 281 (1900), the Court stated:

> "Even if his [defendant's] actual good faith is not questioned, if facts known to him should have led him to inquire, and by inquiry he would have discovered the real situation, in a commercial sense he acted in bad faith and the law will withhold from him the protection that it would otherwise extend." (at 284)

and

> "The facts known to the defendant should have aroused his suspicion and led him, as an honest man, to make some investigation before he accepted the money of a corporation, which owed him nothing, in payment of a claim that he held against someone else. If he had such confidence in Biggs that he was willing to trust him without inquiry, under suspicious circumstances of a substantial character, he must stand the loss, for he failed to discharge a duty required by commercial integrity." (at 285)

In Fidelity & Deposit Company of Maryland v. Queens Trust Company, 226 N.Y. 225 (1919), the Court stated:

> "If a person has knowledge of such facts as would lead a fair and prudent man, using ordinary thoughtfulness and care, to make further accessible inquiries, and he avoids the inquiry, he is chargeable with the knowledge which by ordinary diligence he would have acquired. Knowledge of facts, which, to the mind of a man of ordinary prudence, beget inquiry, is actual notice, or, in other words, is the knowledge which a reasonable investigation would have revealed."

In short, willful ignorance or failure to inquire negates good faith. Otten v. Marasco, 353 F.2d 563 (2d. Cir. 1965); Calvert Credit Corp. v. Williams, 344 F.2d 494 (D.C.Ct. of App. 1968); Blow v. Ammerman, 350 F.2d 729 (D.C.Cir. 1965); and Slaughter v. Jefferson Federal Savings and Loan Association, 361 F.Supp. 590 (Dist. Col. 1973).

The Court below in its decision stated that this Court's opinion in Gutekunst v. Continental Insurance Company, 486 F.2d 194 (2d. Cir. 1973), was controlling (16). The Court cited Gutekunst for the proposition that a bank has no duty to investigate its customer or his right to negotiate bearer bonds. The Court below erred in its interpretation of Gutekunst.

Gutekunst was not intended to set down a blanket rule that under no circumstances must a bank investigate a customer who is attempting to negotiate bearer bonds

or treasury notes through the bank. This Court's holding in Gutekunst was simply that under the facts in Gutekunst, there was no suspicion raised in the bank's mind in that case so as to require it to inquire as to where its customer had obtained the bonds and whether or not he had a right to negotiate them. The Court in Gutekunst went on to state in no uncertain terms that:

> "* * * the New York law is that only actual knowledge or disregard of suspicious circumstances may constitute evidence of bad faith." (at 195-196) (emphasis added)

In our case Mazzochi's conduct was bristling with suspicion. In fact, the bank itself was apparently suspicious of Mazzochi since Santoro claims to have called the Federal Reserve Bank (151, 167) prior to accepting the treasury bills and the proceeds from the last $72,000 were placed in a suspense account by the bank pending investigation as to whether or not Mazzochi was legitimately entitled to cash them (779, 1169).

Under these circumstances, it cannot be disputed that the bank had a duty to inquire of Mazzochi where his sudden new-found wealth had appeared from.

In Otten v. Marasco, 353 F.2d 563 (2d. Cir. 1965), cited with approval in Gutekunst, this Court held that the burden of proof as to whether or not one acts in accordance with reasonable commercial standards is upon the party making that claim and seeking to take advantage of the saving provisions

of UCC 8-318. See, also, Phoenix Insurance Co. v. National Bank & Trust Co. of Central Pa., 366 F.Supp. 340, 343 (M.D.Pa. 1972), aff'd. 485 F.2d 681 (3d. Cir. 1973).

The plaintiff submits that the defendant Royal has failed to meet that burden of proof and to show that it obeyed reasonable commercial standards in accepting $212,000 in treasury notes from Mazzochi under the unusual circumstances which Mazzochi's transactions occurred. Since the bank has failed to meet its burden of proof so as to take advantage of the good faith defense made available to it by UCC 8-318, the bank is liable to USF&G for conversion.

Merrill Lynch

Mazzochi's stolen treasury notes were sold through the bank to the defendant Merrill Lynch. Since Merrill Lynch did not act as a broker or an agent with respect to these treasury notes, but purchased them as a principal, its conduct is not governed by UCC 8-318 as the bank is, but rather is governed by UCC 8-304.

UCC 8-304(3) provides that:

> "Except as provided in this section, to constitute notice of an adverse claim or a defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the security amounts to bad faith." (emphasis added).

The cases and the commentators have clearly held that the failure to observe reasonable commercial standards by a broker would be sufficient to constitute bad faith on its part and the defenses of UCC 8-304 unavailable to it.

One of the primary guidelines of reasonable commercial standards are the rules and regulations of the New York Stock Exchange and other organized exchanges. Rule 405 of the New York Stock Exchange, commonly known as the "know your customer rule" requires each broker to:

> "Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any amount accepted or carried by such organization." (emphasis added)

The failure to observe Rule 405 by a broker and to know its customer leads to the conclusion that a broker was not acting in good faith and should not have the defense of UCC 8-304(3) available to it.

Israel, in his practice commentary in McKinney's to Section 8-304 states:

> "The jeopardy of the selling broker is broadened by the rules and practice of the organized market which require that he 'know his customer'. (See e.g. Rule 405 of the New York Stock Exchange under which the selling broker must 'use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried . . ') The facts gathered in the course

> of compliance with that rule may either constitute the 'knowledge' described in subsec. (2) of this section or, though sort of that, still be sufficient to raise a question of good faith under subsec. (3) of this section. See United States Fidelity & Guaranty Co. v. Goetz, 1941, 285 N.Y. 74, 32 N.E. 2d 798 cited in the Official Comment to this section."

In Hartford Accident & Ind. Co. v. Walston & Co., 21 N.Y.2d 219, 287 N.Y.S.2d 58 (1967), the New York Court of Appeals considered precisely this issue as to whether or not a brokerage firm by failing to know its customer and violating Rule 405 of the New York Stock Exchange could raise the defense of "good faith" to the purchase of stolen securities. The Court of Appeals stated in language directly applicable to this case:

> "* * * brokers cannot shirk these duties and at the same time claim to have acted in good faith without being charged with knowledge of facts which compliance with reasonable commercial standards would have disclosed. (Fidelity & Deposit Co. v. Queens County Trust Co., 226 N.Y. 225, 123 N.E. 370)." 287 N.Y.S.2d at 66

Similarly, in Fidelity & D. Co. of Md. v. Chemical Bank of N.Y.T. Co., 318 N.Y.S.2d 957 (App.Term, 1st Dept. 1970), aff'd. 333 N.Y.S.2d 726 (1972), the Court held that a brokerage firm was liable for conversion when the broker had failed to exercise due diligence in knowing its customer in violation of Rule 405 of the New York Stock Exchange.

The district court's finding that Royal was Merrill Lynch's customer rather than Mazzochi is contradicted by the record since every transmittal slip sent by Royal to Merrill

Lynch with respect to the treasury notes clearly stated "for the account of Frank Mazzochi, Jr." (638-641).

The court below also found that Merrill Lynch had no duty to bypass Royal and inquire as to who Mazzochi was (17). Understandably, the Court below cites no authority for this novel proposition. Merrill Lynch was clearly put on notice by the transmittal slips that its customer was Mazzochi, not the bank, and, accordingly, had an independent duty pursuant to Rule 405 to inquire who Mazzochi was.

In addition, even if we assume that the bank was Merrill Lynch's customer rather than Mazzochi, Rule 405 provides that a broker must not only learn the essential facts relative to every customer, but to "every order." Merrill Lynch clearly did nothing to determine the essential facts behind the orders for the sale of the treasury bills which it knew were for the account of one Frank Mazzochi, Jr. If Merrill Lynch desired to rely upon the fact that the bank had investigated Mazzochi for it and performed the requisite due diligence, then if Merrill Lynch assumed wrong and the bank did not exercise the requisite due diligence, it is Merrill Lynch who must suffer the consequences.

Merrill Lynch by failing to observe reasonable commercial standards, in particular, Rule 405 of the New York Stock Exchange, did not act in good faith as required by UCC 8-304(3). It, therefore, cannot invoke the protective provisions of that section and is liable to USF&G for conversion.

POINT III

THE DOCTRINE OF EQUITABLE ESTOPPEL DOES NOT PREVENT USF&G FROM RECOVERING IN THIS CASE.

The court below in its decision stated that the principle set down in Bunge Corp. v. Manufacturers Hanover Trust Co., 31 N.Y.2d 223, 335 N.Y.S.2d 412 (1972), is applicable to this case (17). Bunge stands for the proposition that as between two innocent victims, the one who permitted the wrong to occur must bear the loss.

As the district court was compelled to admit, the fact situation in Bunge was different from that in our case since Bunge dealt with a situation where its faithless employee had caused the loss through fraud. Bunge did nothing more than reiterate the old rule that it is the employer of the faithless employee who placed its trust in him in the first instance and should bear the loss as between two innocent parties. The court below misconstrued Bunge to mean that the plaintiff is somehow estopped from recovering because it permitted the larceny to occur in the first instance and failed to promptly discover or report the loss. Even assuming that USF&G was negligent, negligence is not a defense to conversion. The Court in Hartford Accident & Ind. Co. v. Walston & Co., supra, stated:

> "The defendant, to whom these shares of stock were delivered for sale, and which sold them and paid the purchase price to a confederate of the thief, either converted this stock or it did not do so, but if there was a conversion it is not a defense that plaintiff's assignor (Bache & Co.) may have been negligent in handling them." 287 N.Y.S.2d at 61.

See, also, Morgan G. T. Co. of N.Y. v. Third Nat. Bk. of Hampden Cty., 400 F.Supp. 383, 391 (D.Mass 1975).

In any event, whatever the rule may be with regard to who must bear the loss among two innocent parties, that rule is inapplicable in our case since the defendants by not observing reasonable commercial standards, despite the suspicious nature of Mazzochi's activities, cannot be said to have acted in good faith or be innocent parties. See Borrello v. Perera Company, Inc., 381 F.Supp. 1226, 1230 (S.D.N.Y. 1974), aff'd. 512 F.2d 1380 (2d. Cir. 1975).

Since we are not dealing with a situation where there are two innocent parties, the Bunge principle of equitable estoppel is, at any rate, inapplicable.

A thief who obtains stolen securities or treasury bills would be unable to dispose of them unless banks and brokerage houses such as the defendants herein totally ignore proper commercial standards and permit the thief or his accomplice to obtain cash for the stolen securities through their offices. The problem of thefts of stocks and bonds has had a dramatic increase in the past few years. The only way to prevent this is to require banks and brokerage houses to properly carry out their responsibilities so that the thief would be unable to dispose of his booty. See generally, Note, Insecure Securities: Theft of Stocks and Bonds, 6 Colum, J. of L. & Soc. Prob. 478 (1970).

Both the bank and Merrill Lynch, had they exercised any diligence at all to discover how Mazzochi came into the possession of these treasury bills, would have discovered that he was not the rightful owner. There was no requirement on the part of either the bank or Merrill Lynch to deal with Mazzochi. If they chose to do so in violation of all reasonable commercial standards, and so far as concerns Merrill Lynch, Rule 405 of the New York Stock Exchange, and by their actions permitted these stolen treasury notes to be converted into cash, they are liable to USF&G.

CONCLUSION

The district court's findings that the defendants observed reasonable commercial standards are clearly erroneous. The defendant Royal disregarded highly suspicious circumstances and accepted $212,000 in treasury notes from Mazzochi and cannot be said to have acted in good faith or observed reasonable commercial standards. Similarly, Merrill Lynch failed to observe reasonable commercial standards or act in good faith by failing to observe Rule 405 of the New York Stock Exchange and to learn who Mazzochi was and how these treasury bills came to be sold. Since the defenses provided to persons who act in good faith by the Uniform Commercial Code are not available to the defendants, they are liable to USF&C for conversion. The judgment of the court below should be reversed in all respects.

Respectfully submitted,

Julien & Schlesinger, P.C.

Alfred S. Julien
Stuart A. Schlesinger
David Jaroslawicz
Samuel Komoroff Of Counsel

A 202 Affidavit of Personal Service of Papers LUTZ APPELLATE PRINTERS, INC.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

UNITED STATES FIDELITY & GUARANTY CO.,.
Plaintiff- Appellant,

- against -

ROYAL NATIONAL BANK OF NEW YORK &
MERRIL LYNCH PIERCE FENNER & SMITH INC.,
Defendants- Appellees.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF NEW YORK *ss.:*

I, **James A. Steele** *being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at* 310 West 146th Street, New York, New York

That on the **27th** *day of* **May** *19* **76** *at* **1) 10 East 40th Street, New York, New York**
2) 11 Park Row, New York, New York

deponent served the annexed **Appendix Brief** *upon*

1) Hart & Hume
2) Konheim, Halpern & Beleiwas

the **Attorneys** *in this action by delivering a true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the herein.*

Sworn to before me, this **27th**
day of **May** *19* **76**

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31 0418950
Qualified in New York County
Commission Expires March 30, 1977

James A. Steele

JAMES A. STEELE